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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

The United Kingdom's Austerity Budget

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
March 1968

INTELLIGENCE MEMORANDUM

The United Kingdom's Austerity Budget

Summary

Faced with near bankruptcy in the wake of the recent international financial crisis, the British government on 19 March introduced the most austere peace time budget in decades. Unexpectedly sharp tax increases on virtually all consumer goods will curtail consumption expenditures, hold down imports, and free additional resources to increase exports. A companion measure, designed to prevent erosion of the competitive edge for British industry bought with the devaluation of sterling last November, sets forth a tight incomes policy that limits the rise of wages and dividends to 3½ percent during the next 12 to 18 months and seeks statutory authority to take direct action against abnormal price increases. Implementation of the draconian measures outlined in the budget would, in the opinion of the British government, replace the deficit on the current external payments position of more than a billion dollars in 1967 with a small surplus in 1968.

With the prospect for declines in real income for most Britons in the next year or two, the budget is expected to run into considerable opposition not only from the Conservatives, but also from the left wing of the Labor Party and from the Labor Members

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of Parliament beholden to the labor unions. Nevertheless, Parliament is expected to approve the budget, if only by a narrow margin. Thereafter, the success of the austerity program will depend on the degree of cooperation forthcoming from labor and industry. If labor's response to the limitation on wage increases is a resumption of the wildcat or general strikes that have plagued previous attempts at restoring the viability of the British economy, the current program may fail, and drastic consequences for the British economy would ensue, which inevitably would affect the stability of the dollar. But if the great majority of labor and management accept the extreme wage and price discipline the program requires, Britain will have taken a long step toward putting its house in order.

Earlier British Actions

1. The year 1967 was a brutal one for the British economy. The slowdown in the growth of world trade, the Middle East War and closure of the Suez Canal, the dock strikes in London and Liverpool -- all contributed to the drastic deterioration in the balance of payments and finally to heavy speculative pressure on sterling, making prompt and radical action necessary. Accordingly, on 18 November, sterling was devalued by 14.3 percent, and the first installment of accompanying measures to check the growth of private and public consumption expenditures was announced.* These measures, which included restrictions on bank lending, a tightening of consumer credit on the purchase of automobiles, and an increase in the central bank rate from 6½ to 8 percent, were designed to buttress the devaluation and further strengthen confidence in sterling. The government recognized that still other measures would be required to further repress domestic demand and to stimulate the shift of resources necessary to improve export performance. On 16 January 1968, it announced budget cuts totaling $720 million for Fiscal Year (FY) 1968/69,** affecting mainly road construction, housing, and education programs, and drastic reductions in military expenditures overseas for 1969-71, especially for British forces east of Suez.

2. These measures, however, were generally regarded as inadequate to insure the necessary improvement in the UK balance of payments. The domestic budget cuts were too small. There was no provision to control the growth of wages, and the cuts in military programs overseas were not to take effect for almost two years; in the meantime they would entail net increases in foreign

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** The British Fiscal year runs from 1 April through 31 March.*

exchange expenditures.* The British government had imposed a wage "freeze" in July 1966, but with a statutory limit of six months. By the time of devaluation the freeze had ended and the government was experiencing increasing difficulty in controlling wages.

Recent Economic Developments

3. As expected, devaluation did not lead to immediate improvements in the balance of payments. Exports rose substantially in January 1968, sharply reducing the trade deficit for the month, but this rise was attributable primarily to "catching up" with shipments that had been delayed by the dock strike of the fall of 1967. The trade balance deteriorated again in February as the volume of imports rose in anticipation of restrictive measures by the government. Earnings on invisible items (such as insurance and freight) remained below expenditures, further widening the payments gap.

4. Because of the renewed deterioration of the balance of trade and the resumption of speculative pressure against the pound, British reserves, most of which already consisted of special drawings and loans, dropped sharply.

The New Budget

5. The budget introduced on 19 March is a draconian one -- tougher than almost anyone had expected. It provides for expenditures of US $27,573 million, an increase of 5.6 percent over the preceding fiscal year, and for revenues of $30,900 million, an increase of 15.2 percent over the preceding year. The planned budgetary surplus of $3.3 billion will enable the central government to finance almost 80 percent of its loans to the public sector out of revenues, sharply reducing its borrowing requirement from an anticipated maximum of $2.4 billion to about $870 million.

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* *Because of penalties estimated at between $150 million and $300 million on the cancellation of the F-111 contract.*

6. The principal revenue measures announced in the budget are increases in:

(a) Excise taxes (especially on betting, liquor, tobacco, and gasoline);

(b) Sales taxes;

(c) Miscellaneous fees (especially on automobiles);

(d) The tax on employment in service industries (the so-called "selective employment" tax).

In addition, some loopholes in existing direct taxes were closed, and previously planned increases in family allowances were cancelled. Details of the budgetary measure are shown in the appendix.

7. The overall increase in the tax bill comes to $2.2 billion. This is equivalent to 2.5 percent of personal income in Britain. A comparable increase in the US tax bill would be about $16 billion.

8. The burden of the tax increase will fall predominantly on consumers, especially in the middle income brackets. In order to minimize the burden on low income groups, taxes on food were not increased. The emphasis on indirect taxes (sales and excise taxes) as opposed to direct taxes (those on income) was designed to penalize consumer spending without discouraging savings and investment. Direct taxes in Britain are already high across the board and they take a larger cut of the higher incomes than in the United States. It was feared that further increases in direct taxes would have an adverse effect on incentives to save and invest. The new budget left income tax rates untouched, but retained the 2½ percent increase in the corporation tax announced on 18 November 1967. To bring the higher income classes more directly within

the scope of the austerity program, a "one-time-only" special charge was put on income from investments for the fiscal year just ending. Coupled with taxes already in existence, the new special charge means that some persons will actually have paid a tax of at least 100 percent on their investment income. Because this charge is on past income, however, it is similar to a tax on wealth and is not expected to have an adverse effect on future investment. The decision to emphasize indirect taxes took a great deal of political courage, especially for a labor government.

9. The new budget did not add to the cuts in public expenditures announced 16 January. The government noted that welfare programs in Britain are not out of line with those in other European countries and judged that further cuts in these programs would be politically more distasteful than cuts in private consumption.

10. To insure that the tax increases would result in a cut in consumption and to protect the competitive edge for British industry gained as a result of the devaluation, the government set forth an incomes policy designed to limit wage and price increases. The government proposes to hold wage increases to 3½ percent for at least the next 12 to 18 months, with larger increases granted only in exceptional cases where substantially greater gains in productivity can be shown. The 3½ percent limitation also will apply to dividends. In addition, the government will seek authority to intervene directly in cases involving large price increases. Nevertheless, prices are expected to rise faster than wages. Before the budget was announced the National Institute* projected a 5½ percent increase in the cost of living between the fourth quarters of 1967 and 1968, primarily on the basis of rising import prices and labor costs. If the unexpectedly tough incomes policy just announced is applied, labor costs will rise much less than the National Institute projected. As a result, the increase in the cost of

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* *The National Institute of Economic and Social Research is Britain's most prestigious private research organization.*

living should also be less than the National Institute projection, even though higher indirect taxes will be passed on to consumers in the form of higher prices. In any case, the purchasing power of individual consumers will decline.

Short-Term Economic Effects of the Budget

11. The budget gives effect to the government's program for greatly improving the UK's external payments position and laying the foundations for sustained economic growth. The main targets of this program are increases* of: (a) 11 percent in the volume of exports of goods and services with no appreciable change in the volume of imports of goods and services, (b) 7 percent in private investment, (c) 2 percent in government current expenditures, (d) 2 percent in government investment outlays, and (e) 3 to 4 percent in gross domestic product. In order to achieve these growth rates, private consumption expenditures must be curtailed by about 1 percent.

12. The export goal seems reasonable. The decline in exports in 1967 (0.6 percent) reflected the West German recession, slow economic growth in France and the Netherlands, the dock strike in the United Kingdom, and the general slowdown in the growth of world trade. Substantial improvement in demand for British goods in 1968 is expected because economic prospects in Germany, France, and the Netherlands are brighter. Moreover, sterling devaluation gave a number of British exports a competitive edge, permitting some British producers to cut export prices and others to earn larger profits on their export sales, which increases their interest in the export market.

13. Reductions in tariffs pursuant to the Kennedy Round also should aid British exports. In addition, the adoption of the Common External Tariff by the Common Market countries effective 1 July 1968 may be a further stimulus because the attendant large reductions in French and Italian tariff rates are more important to British exporters than the simultaneous small increases in

* *Per annum rates for the next 18 months.*

West German and Benelux tariff rates. The anticipated shrinkage of the domestic market also will put greater pressure on British manufacturers to export in order to maintain or increase their total sales. Substantial increases in export orders, especially for automobiles and chemicals, already have materialized. As domestic demand declines, British industry should be able to improve service to foreign customers and offer quicker delivery.

14. If exports of goods and services grow as planned and imports do not increase appreciably, the current balance will shift from a deficit of more than a billion dollars in 1967 to a small surplus in 1968. The surplus should increase further in 1969 as the full effects of the devaluation on exports are manifested. It is difficult to predict the trends in the overall British balance of payments because of the unsettled condition of international money markets and the uncertain effects of the recent US restrictions on private investment abroad. Unless the movement of private funds is highly unfavorable to the United Kingdom, however, it should be able to generate a sufficient surplus in the next year or two to make substantial repayments on its obligations to the International Monetary Fund and to foreign central banks. The greatest uncertainty concerns the disposition of Britain's short-term debts -- the sterling balances held by foreign governments and individuals, which greatly outweigh Britain's liquid foreign assets. There is an ever-present danger of attempted massive conversions of these balances into other currencies. Conversions into gold are still possible, but on a much reduced scale because the United States and other major financial powers stopped selling gold to the free market. Britain's short-term foreign currency needs have been covered by large new central bank credits provided on 17 March 1968. It is possible that the crisis in the international monetary system will stimulate efforts to find a means of converting some of Britain's sterling balances into long-term debts, thereby removing the speculative danger.

The Longer Term

15. The British government can justify before the British people the severe sacrifices it is expecting them to make only if it can show that these sacrifices will not be permanent and are necessary to get the economy moving again. The long-term objective of the budget is to get Britain out of the vicious circle in which it has been caught since the early 1950's -- an inadequate growth of exports, which forced every period of economic expansion to be halted prematurely for lack of foreign exchange; a low rate of investment stemming from the weakness of economic expansion; and a sluggish growth of productivity, partly resulting from the low investment, which in turn hurt the competitiveness of British exports. In the long term, Britain will have to increase its exports more rapidly, not only in periods when domestic demand is low, as will be the case in 1968, but also in periods when the domestic economy is expanding. To achieve this, investment must be redirected toward industries in which Britain's competitive position is strongest (such as organic chemicals, machinery, and electronic equipment). The British government hopes that investment in such industries will do considerably better than the 7 percent increase planned for total private investment in 1968. It also hopes that Britain can achieve by 1969 a balance-of-payments surplus large enough to allow room for more rapid expansion of the economy in subsequent years without generating another foreign exchange crisis. Whether the new budget will put Britain on the road to rapid export-oriented growth is of course uncertain. But it does just about all a British government could do at this time to bring about this result.

Political Aspects

16. The success of the budget depends largely on the degree of acceptance and support it receives. The increases in taxes and restraints on wages, prices, and dividends aroused the expected resentment of trade union leaders, Labor

Party left-wingers, and the Confederation of British Industries. The program also received heavy fire from the conservative opposition in Parliament, directed primarily at the 3½ percent limitation on wage and dividend increases. In fact, the Labor left wing and the unions voiced opposition to the tax increases because they do not "soak the rich."

17. The budget is likely to receive Parliamentary approval within two or three weeks, despite the opposition it will face. Beyond Parliamentary consent, the effectiveness of the program will depend on the degree of compliance it receives from trade union and industry leaders. One of the biggest dangers is that widespread labor dissatisfaction could lead to strikes and slowdowns in key industries.

APPENDIX

Austerity Measures of the United Kingdom

Measures	Change	Expected Yield
Announced 18 November 1967		
1. Corporation income tax	From 40% to 42½%	a/
2. Bank rate	From 6½% to 8%	
3. Installment purchase regulations for automobile purchases	From 33-1/3 months to 27½ months	
4. Rebate export	Abolished	
5. Government spending	Cuts	480
6. New tighter restrictions on bank lending		
Announced 16 January 1968		
1. Public expenditure cuts		720 b/
a. Education		233
b. Investment grants	Repayment time lengthened	192

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Measures	Change	Expected Yield (Million US $)
Announced 16 January 1968 (Continued)		
c. Housing and road construction		
d. Welfare and health programs		295
e. Family allowances		
f. Civil defense		
g. Defense spending		Not effective until FY 1969/70
Announced 19 March 1968		
1. Betting, gaming, and gaming license duties		72
2. Spirits	Up 30¢ per bottle	14
3. Wines	Up 6¢ per bottle	17
4. Tobacco	Up 2¢ to 4¢ per package	72
5. Gasoline	Up 4¢ per gallon	182
6. Purchase tax (on most goods other than food, and luxury goods)	11% to 12½% 16½% to 20% 27½% to 33-1/3% 33-1/3% to 50%	391

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Measures	Change	Expected Yield (Million US $)
Announced 19 March 1968 (Continued)		
7. Vehicle licenses	From $42 to $60	302
8. Selective employment tax (net)	Up 50% to $4.50 per week	365
9. Direct taxes	Closing of loopholes in existing legislation	418
10. Corporation tax and recovery of 7 shillings increase in family allowance	Tax increase, allowances cut	377
11. Limitation on wage and dividend increases of 3½% of amounts paid out in previous years		

a. See measures announced in March.
b. For FY 1968/69.